

CFTC Ex. 409

Message

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Sent: 2/18/2019 12:06:18 PM
To: eric232@gmail.com
CC: Ben Cybulski [bcybulski@longleaftrading.com]
Subject: Per our conversation
Attachments: Bond Replacement Strategy.pdf

CFTC EXHIBIT

409



Bond Replacement Strategy

To provide more insight after our discussion, we will outline the trading strategy that we have been using for some of our clients to provide returns on idle capital in their accounts. The targeted return for this type of trade is 6-10% per year after fees and commissions. The trade is not without risk; however, it is always defined and actively managed.

Target Market

The target market of this trade is higher wealth individuals looking for slightly higher returns than traditional fixed income products. The fixed income products which we target are cash management products (short term CDs or money market funds) and medium duration investments (2-5-year bonds). Given the larger capital requirements than traditional option trades and a slightly longer duration, a significant capital amount is recommended.

Trade Structure

In its simplest form, it is buying a future asset with a known value and then financing that asset through the option sales over time. Profitability is derived by the option sales plus the asset value to exceeding the value of the initial purchase. We focus these strategies on very specific futures that meet certain criteria: quarterly futures, weekly options, low historic volatility and adequate volumes. The main futures we use are bonds and currencies as they best meet our criteria.

Using a very common covered trade strategy, we construct option spreads of both a covered call and covered put which create the future asset. By buying in-the money options, the resulting trade creates an asset with a known intrinsic value. By selling out of the money options, we generate financing proceeds to create profits.

The profitability is primarily driven by the time decay variance between the shorter dated options and the longer dated options. Time decay in options is the most predictable variable and therefore creates a higher probability of success. By designing the trade to have lower probability of the sold options being in the money, we mitigate risk of the trade. While volatility is not a major component of the trade, it does provide some upside and downside to the overall trade. This is also why we use lower volatility futures to mitigate the impact on the trade.



Our Value Proposition

Our value is driven by our ability to effectively design and execute this strategy. This is a non-directional trade with a great deal of trade management to ensure that the trade is effective. In designing this strategy, we looked at the inherent weaknesses of the traditional covered strategy:

Weakness	Mitigation techniques
Directional: A traditional covered call strategy is directional in nature and thus if the price would move in the opposite direction, the trade would reflect a substantial loss.	Non-directional: By pairing both a covered call and covered put, this eliminates the directional bias from the trade making it non-directional.
Exceeding price of out of the money options: The movement of price causing the out of the money sales of options to be in the money. This would cause a loss on the overall trade should it be severe enough.	Only one can exceed price: While this risk can never be fully mitigated and there is a risk of loss, both out of the money options can never become in the money. Also, by playing the trade out over longer periods, there is a chance to recover before the options expire.

Trade History

Contract	Month	Premium Paid	Fees & Commissions	Entry Cost	Net Exit Price	Profit and Loss	Gain/Loss%
Bonds	August	(6,703.13)	(67.68)	(6,770.81)	6,416.64	(354.17)	5.23%
Canadian Dollar	October	(5,810.00)	(70.48)	(5,880.48)	6,004.76	124.28	2.11%
Bonds	July	(5,843.75)	(67.32)	(5,911.07)	6,119.51	208.44	3.53%
Bonds	September	(7,681.25)	(65.49)	(7,746.74)	8,180.57	433.83	5.60%
Bonds	January	(5,460.25)	(89.32)	(5,549.57)	5,536.94	(12.63)	0.23%
Bonds	January	(5,796.88)	(66.99)	(5,863.87)	5,990.09	126.22	2.15%
Bonds	January	(3,656.25)	(66.99)	(3,723.24)	3,899.26	176.02	4.73%
				(41,445.78)	42,147.77	701.99	1.69%

Risk Discussion

Typically, the duration of the trade is 7 to 14 days. The critical risk exposure to the trade is the sales of options. If the sold option becomes in the money, we would have to repurchase the option thus reducing or eliminating profitability on the trade. To mitigate this risk, one of the two options sold are often outside or equal to the strikes of the long options. We monitor the trades constantly and communicate any changes. Often, we will ask for permission to make an adjustment to assure we can promptly react to changes in the market. Your approval does not mean that we will always execute the trade but by thinking ahead we can manage the trade more effectively.



Seasonality

The trade does have seasonality. The trade works best when there is a significant amount of time between the short options and long options which creates the highest variance in time decay. For bond quarterly futures, this means March, June, September and December but also means that February, May, August and November are times when the time decay variance is the lowest. For these months, we often use currencies since they expire about 2-3 weeks after the bond quarterly future expires. However, currencies tend to have slightly higher volatilities in general, but we have many to choose from (Euro, Australian Dollar, Canadian Dollar, Pound Sterling, Yen).

Thank you for the opportunity to provide you this insight and look forward to further discussions.

Regards,

Jim Donelson

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Risk Disclosure

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